VZCZCXRO7476
PP RUEHDE RUEHDIR
DE RUEHKU #1626/01 3191604
ZNY CCCCC ZZH
P 151604Z NOV 07
FM AMEMBASSY KUWAIT
TO RUEHC/SECSTATE WASHDC PRIORITY 0282
INFO RUEHZM/GULF COOPERATION COUNCIL COLLECTIVE PRIORITY

C O N F I D E N T I A L SECTION 01 OF 04 KUWAIT 001626

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FOR EB/ESC

E.O. 12958: DECL: 11/13/2017
TAGS: EPET PGOV
SUBJECT: RESOURCE NATIONALISM: NOT THE MAIN OBSTACLE TO FOREIGN PARTICIPATION IN KUWAIT'S OIL SECTOR

REF: SECSTATE 150999

Classified By: Acting DCM Tim Lenderking for reasons 1.4 (b) and (d).

Summary and Comment

¶1. (C) While resource nationalism was a factor leading to the nationalization of Kuwait's oil industry in the mid-70s, and populist and or Islamist MPs still use nationalist language in public comments on Kuwait's oil sector, resource nationalism is not the biggest obstacle to opening Kuwait's oil sector to greater involvement by foreign companies. Overall, resource nationalism seems to be diminishing slightly in Kuwait as evidenced by recent public and private statements by the Amir, Prime Minister, and oil sector officials. Even in the Parliament, the Government estimated in early 2006 that draft legislation to invite international oil companies (IOCs) to participate in Kuwait's upstream oil industry would pass with 33 out of 50 votes. Nevertheless, obstacles to greater IOC participation remain. First, ongoing political wrangling between the Government and the Parliament has led to a legislative stalemate in which important draft laws are shelved indefinitely, ministry officials are risk-averse to the point of paralysis, and special interests and populist showmanship trump the national interest. Second, the enormous wealth created by high oil prices diminishes the incentive to liberalize the oil sector while contributing to perceptions that oil revenues are rising much faster than the country's need for the money and "oil in the ground is better than money in the bank."

¶2. (SBU) The common interpretation of Kuwait's constitution holds that no entity other than the state may take an equity interest in the country's upstream oil and gas resources. However, recognizing that some kind of cooperation with international oil companies (IOCs) will be critical if Kuwait is to achieve its ambitious oil and gas production targets, the leaders of Kuwait's oil sector are exploring different contractual models to take advantage of IOC technology and expertise without conceding equity. In the most tangible sign of progress, Kuwait Oil Company signed a Heads of Agreement (similar to an MOU) with ExxonMobil in July 2007 to develop Kuwait's heavy oil reserves. End Summary and Comment.

Background: Foreign Oil Companies and Kuwaiti Politics

¶3. (C) Kuwait Oil Company (KOC) was formed in 1933 as a joint venture between BP and Gulf. Commercial production began in 1946 and reached a historic maximum of 3.2 mb/d in 1972. Seeking higher profits and greater control, Kuwait nationalized KOC in 1975. In the onshore neutral zone, Kuwait nationalized American Aminoil in 1977, although it allowed Japanese Arabian Oil Company to continue to operate in the offshore neutral zone until its concession expired in

¶2003. Following the steep drop in oil prices in the early 80s, KOC tried to ramp up production, which had reached a low of 824,000 b/d in 1982 but found itself constrained partly by OPEC quotas but mostly by limited production capacity. Even after recovering from the damage sustained during the 1990-91 Iraqi invasion and occupation, KOC has struggled to meet its production goals. Now producing roughly 2.5 mb/d, Kuwait has failed to reach its goal of producing 3 mb/d by 2005 and seems to be making little progress towards its revised goals of producing 3 mb/d by 2010, 3.5 mb/d by 2015, and 4 mb/d by
¶2020. Current and former leaders of Kuwait Petroleum Corporation and Kuwait Oil Company have told Post that they will need the help of the IOCs to reach these targets.

¶4. (C) Although Kuwait's constitution grants the State the exclusive power to exploit, utilize, and safeguard Kuwait's oil
resources, it also gives the State the right to grant concessions for a limited time by the passage of an enabling law.
In 1997, Kuwait's Supreme Petroleum Council approved the concept of allowing foreign oil companies to participate in development of Kuwait's northern oil fields and tasked KOC with developing proposals as to what form foreign participation might take. Since Kuwait's constitution forbids foreign ownership of upstream oil and gas resources, traditional production sharing agreements were off the table. There were two principal reasons for the proposal, which became known as Project Kuwait. First, from an engineering and geological standpoint, the northern fields are difficult to develop, and KOC needed the help of IOCs to boost their production. Second, following liberation, the Kuwaitis hoped that the presence of major international oil companies near the border with Iraq would give the U.S, UK, and France an

additional incentive to continue to protect the integrity of that border.

¶5. (C) Draft legislation was introduced in Parliament in 2003 enabling Kuwait Petroleum Corporation (KPC), the parent corporation of Kuwait's state-owned petroleum companies, to sign contracts with foreign oil companies giving them operational control over certain oil fields. The Parliament's Financial and Economic Affairs Committee began to study the legislation in 2004 and issued a favorable report in 2005. However, after the State Audit Bureau questioned the constitutionality of the legislation, the committee withdrew the report. The Government estimated that the legislation would pass with the votes of 33 out of the 50 elected members of Parliament but, considering this too small a majority, decided to defer the vote. Anticipating the eventual passage of Kuwait Project, KPC created a new subsidiary, the Oil Development Company, in 2005 to supervise the participation of foreign companies. In January 2006, the Amir died, and the vote was delayed to accommodate the mourning period and succession. In May 2006, the new Amir dissolved the Parliament due to ongoing confrontation with the Government. The new Parliament was elected in June 2006 and a new Government was appointed in July. However, the new "reformist" Parliament took a number of Ministers to task on alleged corruption issues until the Government decided to resign in March 2007.

¶6. (U) A new Government was appointed later in March 2007, but the relationship between the Government and Parliament continued to be adversarial with Oil Minister Shaykh Ali Al-Jarrah Al Sabah resigning in June 2007 following a Parliamentary grilling over alleged corruption. In an effort to alleviate the ongoing friction, the Amir reshuffled the Cabinet in October 2007, appointing Former Finance Minister Bader Al-Humaidhi to the position of Oil Minister. However, MPs continued to target Al-Humaidhi over alleged mismanagement of public funds during his tenure as Finance Minister, until Al-Humaidhi was, in turn, forced to resign in November 2007 after eight days in office. Electricity and

Water Minister Mohammed Al-Olaim currently serves as Acting Oil Minister.

Current IOC and Oil Service Company Presence

¶7. (SBU) International oil field services companies are prospering in Kuwait. The lack of technology and expertise within the state-owned companies combined with the very limited role of IOCs leaves a vacuum for contractor services that has been lucratively filled by Halliburton and Schlumberger, which each have several hundred employees in Kuwait. The IOCs, in a holding pattern since the Project Kuwait proposal was first put forward a decade ago, have maintained a token presence in Kuwait in order to have a foot in the door when an opportunity finally presents itself. Currently, BP and Chevron each have about 20 engineers and technicians in Kuwait, down from 30 and 40 respectively last year. BP is working in the North and West, Chevron is working in Burgan. Total has 15 people spread around the country, but concentrated in the onshore neutral zone. Shell has one consultant working downstream in refineries. ExxonMobil has a handful of engineers working on specific projects around the country. KOC is eager to have more IOC engineers working in Kuwait, but in the absence of the ability to book reserves or very high fees for services, IOCs have little incentive to draw their relatively scarce personnel resources away more profitable projects in other countries.

Project Kuwait Prospects Grim

¶8. (C) In Post's assessment, the short-to-medium-term outlook for Project Kuwait is bleak. Despite press statements in April by the Amir, Prime Minister, and Oil Minister in apparent support of the Project, the combination of strained relations between the Parliament and the Government, exceptionally strong government finances, and a lack of consistent leadership in Kuwait's oil sector (eight ministers in the 16 years since liberation compared to Saudi Arabia's three oil ministers in the last 45 years), all diminish the chances of getting Project Kuwait through the Parliament. As a result of the continuing barrage of corruption allegations, the Government has been risk-averse in the promotion of major projects, and MPs have been especially aggressive in scrutinizing and obstructing such projects. One embassy contact from the Supreme Petroleum Council says that most MPs understand the need for Project Kuwait but continue to play politics and cater to special

interests, allowing patronage and tribalism to trump broader, long-term national interests.

¶9. (C) Under the terms of the existing draft legislation for Project Kuwait, generally described as an Operating Service Agreement (OSA), IOCs would be paid fixed fees per quantity of oil and gas produced up to a baseline level, with the fee per barrel increasing for any production beyond this threshold. The current draft contracts were prepared as commercial
agreements between two companies: Kuwait Oil Company and an IOC. Some MPs now argue that these contracts should be rewritten as government contracts which would have to adhere to more stringent standards. When the draft contracts were last reviewed by the IOCs in 2003, the IOC country managers said that the terms and conditions were not economically attractive enough. These IOC managers now suspect that the current terms and conditions of contracts would not reflect current market conditions, so even if the Project Kuwait legislation is approved by the Parliament, the major IOCs may decline to bid.

¶10. (U) Over the past few years, Kuwait's economy has grown significantly on the back of high oil prices. The economy

still relies on the petroleum sector for about 50% of GDP, 95% of exports, and 90% of government revenue. GDP growth last year was approximately eight per cent. In the fiscal year that ended on March 31, Kuwait is estimated to have amassed a USD 17 billion budget surplus (19% of GDP). The 2006/7 trade surplus is estimated to be USD 40 billion (44% of GDP). Overall, the Kuwaiti public enjoys a high standard of living and economic security supported by a cradle-to-grave welfare state. In this context, the Kuwaiti public does not perceive any pressing economic need to grant foreign entities a major stake in Kuwait's oil resources, which many still consider to be their national patrimony.

New models for IOC participation

¶11. (C) In the long absence of any progress on Project Kuwait, KOC managers and some of the IOCs are now pursuing "enhanced" technical service agreements (ETSAs) as an alternative. In order meet its production targets, KOC recognizes that more IOC technology and expertise will be needed to develop more complex reservoirs and process heavier and more sour crudes. Under the ETSA model, Kuwait would pay premium prices to have IOCs assign engineers and managers to Kuwait Oil Company as long-term consultants. High fixed fees would be complemented by variable, performance-based pay contingent upon meeting agreed production targets. The KOC Chairman told the Ambassador in January 2007 that under existing TSAs the IOCs do "everything for us" (i.e. provide assistance with exploration, reservoir mapping, production planning, and field operations), and "they don't get paid enough for doing it." Outgoing KPC CEO Hani Hussein told the Ambassador in early May that he had convinced then Oil Minister Shaykh Ali Al-Jarrah Al-Sabah that ETSAs are an excellent option. Furthermore, he said he had linked bonuses for KOC managers to the effective crafting and implementation of ETSAs.

ETSAs with BP and Chevron?, JV with ExxonMobil?

¶12. (U) KOC announced in October that it has signed a Heads of Agreement (similar to a memorandum of understanding) with ExxonMobil to develop its heavy oil reserves under an ETSA. As Kuwait's light crude reservoirs age, KOC will increasingly need to turn to its abundant heavy crude reserves to meet its ambitious oil production targets. According to KOC Deputy Managing Director for North Kuwait Khalid Al-Sumaiti, as reported in the Middle East Economic Digest, "The plan is to have heavy oil constituting almost 25 per cent of Kuwait's 2020 oil production." Yet, KOC has almost no experience with heavy oil production, processing, or marketing, so under the terms of the prospective deal, Exxon would be "involved in all aspects of the production chain from upstream to downstream", said Al-Sumaiti. "We will use the enhanced TSA framework for the upstream element, and probably a joint venture for the downstream aspect (which is not subject to the constitutional restriction on foreign equity)." The final terms will be ironed out once a feasibility study is completed in July 2008.

¶13. (C) Separately, both Chevron and BP are believed to be in the advanced stages of negotiating ETSAs with KOC for the Burgan field and Kuwait's Western oil fields respectively. KOC seems to be proceeding on the hope that the ETSA framework will obviate the need for parliamentary approval. The Parliament is bound to watch developments closely. Populist MP Ahmed Al-Saadoun, a long-time critic of IOC

involvement in Kuwait, has already demanded clarification
from
the Oil Ministry on the terms of the Exxon deal.

¶14. (C) Current KPC CEO Saad Al-Shuwaib has direct experience with the benefits of partnering with an American multi-national as former CEO of Kuwait's Petrochemical Industries Company, which has enjoyed a hugely successful joint venture (known as Equate) with Dow Chemical since 1995. Al-Shuwaib already has plans to replicate the model in some of KPC's overseas investments and is likely to be supportive of additional downstream joint ventures and upstream ETSAs within Kuwait's borders.

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